Southesk

ENERGY LTD

ANNUAL REPORT

1997

President's Message

To The Shareholders

This report marks the conclusion of three years of operations for Southesk Energy Ltd. as an oil and gas fund, specializing in the investment of junior to mid-sized oil and gas companies. We continue to have success, as indicated in more detail on the following pages, but our portfolio growth exhibits a high degree of volatility due to exploration success or failure, imprudent oil company corporate decisions, and of course, to the widely fluctuating price of crude oil and natural gas.

Oil and natural gas prices were very high in January 1997; both have fallen in value since, adversely affecting the subsequent share performance of the majority of the oil and gas companies, including but not limited to our investments. The Iraqi situation continues to be a deterrent to higher oil prices. The continued lack of transportation facilities within Canada to "take-away" additional volumes of natural gas prevents Canadian natural gas producers from receiving market value for that commodity. No new gas transmission facilities will be operational for at least one more year, perhaps longer.

At year-end, the Southesk Energy Ltd. portfolio had a market value of $3,568,873 compared to a cost of $2,938,170. Corresponding values one year ago were $1,455,000 and $1,577,000 respectively.

In the 1996 Annual Report, mention was made of a decision by the Board of Directors to invest up to 10% of the fund in oil and gas exploration or development "plays." The reasons for this decision are twofold:

(i) exploration expenditures can be written off completely in the year they are incurred, thus reducing taxable income by a like amount in the same year, or carried forward to be applied against taxable income in future years, and (ii) the possibility of being successful in an oil or gas venture would enable the fund to receive, within a short period of time, cash flow to provide additional funds for investment. Our participation thus far in this area consists of acreage purchases in the potential Red River oil play in southeastern Saskatchewan. Southesk Energy Ltd. will be a full partner in the possible acquisition of additional acreage, related seismic surveys, and the drilling of one or more wells. Drilling of the first well is to commence within the next six weeks, actual start date dependent upon drilling rig availability.

In January, Southesk Energy Ltd. offered for sale a new issue of Series "A" Preferred Shares of the Corporation. Such shares pay a dividend at the rate of 6% per annum, such dividends to be paid semiannually commencing September 30, 1997. The Preferred Shares are convertible on the basis of 2 common shares for each preferred share, at any time within five years of the date of issuance of the shares. The offer provided Southesk an additional $2.8-million for investment purposes. The annual preferred dividend requirement is $180,000 and Southesk Energy Ltd. is well able financially to meet this obligation.

At year end Southesk had $630,703 in unrealized gains from its investment portfolio. The Company will remain mainly an oil and gas fund with Frank McEachern as our advisor. Frank will address the shareholders at the annual meeting to be held in Edmonton at the Petroleum Club.

Respectfully submitted,

R.G. Ingram, C.A.
President

This Year in Review

AN INTRODUCTION

Frank D. McEachern

is an independent oil & gas analyst based in Calgary, Alberta. He is the author of the monthly McEachern Oil Letter and serves as the advisor to Southesk Energy Ltd.

Merger/acquisition activity in the oil industry continues unabated, unchanged in level of activity in the past two years, and the process is likely to continue through 1998. Small-cap companies are looking to merge with, or acquire companies of similar size, to reach production levels of 2000+ BOE's per day (barrels-of-oil-equivalent), and also to have access to a larger land base with oil and/or gas potential. Many smaller companies are by nature land poor, and without acreage to drill, leaving a very limited opportunity for growth.

In the case of larger-cap companies, it is common at the moment for large companies to make an offer, preferably friendly but sometimes hostile, to a smaller company having similarities in geographical areas of operation, or other overlapping considerations.

Once again, one of our previous portfolio holdings - Fossil Oil & Gas Limited - became a takeover candidate and our shares were sold into the market following a $3.75 per share offer by another company. One of our current holdings disappeared as at August 1 into another company on a share exchange, and we continue to hold shares of the new entity - Seventh Energy Ltd. Another of our investments is almost certain to be purchased by an as yet unidentified buyer, and a third has made itself available for possible purchase.

In spite of the volatility continually experienced in the oil and gas sector, we are pleased with the overall performance of the fund. As noted on these pages one year ago, perception in the market place of success or apparent failure plays a significant role on individual share trading performance, and hence on price. Even so, the value of the portfolio and the share value continues to increase.

We continue to seek out attractive investment situations. The portfolio components as at June 30, 1997 are reviewed briefly on the following pages.

I look forward to meeting you once again at the 1997 annual meeting of shareholders of Southesk Energy Ltd.

Chauvco Resources Ltd.
(CHA-TSE)

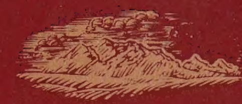
This Company is definitely for sale, and an investment by Southesk Energy Ltd. was made accordingly. The current share price of $20.00 is well ahead of our average cost purchase of $16.37. At the time of writing, there is no visible buyer, nor a likely price, but something in the range of $25.00 is possible. Given that the market-capitalization of CHA is in the $1-billion range, it is obvious that a buy-out must come from an equally large or larger corporation.

Canadian Conquest Exploration Inc.
(CCN-TSE)

Shares in CCN were first purchased in August 1996 at a cost of $1.50 per share. The Company had recently undergone a significant reorganization with new management providing additional financial support. A few months later the shares reached $2.85, but have declined ever since to approximately one-half of that value, even though cash flow per share doubled in 1996 from 1995. During May 1997, the Board of Directors of CNN agreed to the retaining of an investment advisor "...to assist in a review of strategic alternatives available to the Company to maximize shareholder value." In other words, to seek a potential merger candidate, or be acquired by another company. Southesk added to its holdings at this point to take advantage of the potential corporate change, unfortunately, nothing transpired. The Company terminated discussions as no merger or sale transaction became available on suitable terms, and "...will focus its value enhancement efforts on various opportunities recently identified." Unfortunate also is the attitude of the investment community related to that misadventure, and CCN shares now trade in the $1.35 - $1.40 range.

Hurricane Hydrocarbons Ltd.
(HHL.A-TSE)

Our shareholdings of this Company were purchased at various times during the past one and one-half years at an overall average cost of $4.25 per share. HHL recently concluded the purchase of all of the assets of Yuzneftegaz, the Kazak national oil company. Production net to HHL now exceeds 47,000 barrels per day, and upgrades to existing wells, gathering lines, infill drilling, etc. will add to those volumes. In a recent presentation to over 110 institutional portfolio fund managers, oil analysts and others, the Company made a cash flow forecast for calendar 1997 of $73-billion (U.S.), equal to $2.00 per share (Can.). Export markets to the east (China), and southwest (Turkmenistan) are being evaluated to complement the increased usage of oil in the domestic (Kazakstan) market. The potential for growth continues to look very positive for the Company and we intend to maintain our shareholdings for additional capital appreciation. A Calgary-based independent consulting firm estimated year-end (June 30, 1996) proven reserves to have a value of $730-million (U.S.), or about $1-billion (Can.), equivalent to approximately $ 20.00 per share. Even if only 50% of the value is there, the remainder still represents a value of $10.00 per HHL common share.



Newport Petroleum Ltd.
(NPP-TSE)

Our first purchase of NPP shares occurred in August 1996 at a price of $5.08 per share. Since then we have doubled our holdings via two more purchases, with our average cost now $6.40 per share. Corporate performance has been excellent ever since inception in 1992. The friendly takeover earlier this year of Cimarron Petroleum Ltd. by NPP resulted in a significant drop in share value, attributable at least in part to the view that the purchase of CIR came at too high a price. For the moment, that opinion continues to hold sway in the market place, but NPP is now a larger entity, well funded, very capably managed, with a large portfolio of oil and gas properties, undeveloped acreage and is expected to perform very well in the coming years.

This Year in Review cont...

Oiltec Resources Ltd.
(OLT-TSE)

A year ago, we described the formative years of this excellent oil and gas company, and stated that the fund owned 150,000 shares. Our ownership now is 241,500 shares at an average cost of $1.20. In addition, we have share purchase warrants permitting us to buy an additional 71,500 OLT shares this year at $1.75 per share for a total weighted average cost of $1.33 per share. In the "President's Message" portion of this report, reference was made to participation by Southesk Energy Ltd. in the Red River oil play in southeastern Saskatchewan. We are partners with Oiltec Resources Ltd. in a very meaningful way in that prospect, but at the time of writing, we are not able to provide more details, but should be able, either in the Q-1 report of fiscal 1998, or at the upcoming annual meeting of shareholders of Southesk Energy Ltd., to provide information on progress thus far in this exciting exploratory program.

Palliser Energy Inc.
(PSR.A-TSE)

This Company represents the largest shareholding of the fund, currently second largest in value. The average cost of the 437,500 shares is $0.75 per share, which compares very favourably with recent market prices in the $1.25-$1.30 range. In addition to exploration for, and development of conventional oil and gas reserves, PSR ownership of Petro Well Servicing provides significant cash flow from the continual servicing of oil and gas wells throughout western Canada. Workovers are undertaken frequently during the productive life of a well. The Board of Directors of Palliser Energy Inc. has now decided to divide the company into two separate entities:
(i) oil and gas, and
(ii) service rig operations. As it is now, both segments compete for available capital under the "Palliser" name, limiting the ability of each to grow at its own rate. This transaction is subject to the usual approval from shareholders, favourable tax ruling, etc. and may be concluded satisfactorily by mid-to-late August. Current shareholders of Palliser Energy Inc. will receive an identical number of shares of the service rig Company. Because the Company will be divided into two separate entities, the share price of the current "Palliser" may well fall initially to the $0.65 - $0.90 range, because the financial contribution from Petro Well Servicing is no longer available. Similarly, the service rig shares may trade more on an earnings, rather than cash flow multiple, and they too may initially trade in the $0.70 range. The upside potential for both oil and gas, and well servicing components is considered excellent.

Pointer Exploration Corp.
(PE-TSE)

Our initial investment in this company occurred in April at a cost of $1.26 per share. There are two reasons for making this purchase: (i) the "bread and butter" activities of the company in the Drumheller area of southern Alberta; and (ii) the company ownership (16%) of Vinland Petroleum Inc., a Newfoundland oil and gas company with large acreage holding both on and offshore Newfoundland.

The company year-end is also June 30, and while no data are as yet available, it is fairly well known that PE had an excellent year in the Drumheller project, drilling many successful oil wells, and making a significant addition to reserves and production. Much undrilled acreage remains to be evaluated in the coming months.

Vinland Petroleum Inc. was established several years ago to explore for oil and natural gas both onshore and offshore western Newfoundland. The Company is private (likely to become public within the next 6-12 months), owned jointly by PE (16%), six individuals, and a second corporation. The first of probably five or even six onshore wells is now being drilled by a company which farmed-in to Vinland acreage.

Very recently, the Board of Directors of Pointer Exploration Corp. decided to follow in the footsteps of Canadian Conquest Exploration Inc. and seek a merger candidate, if possible. A data room has been set up, with admittance restricted to a select few companies located in Calgary. Positive comments have been received by the Company by one or more of those permitted to examine the data, but at the time of writing no decision has been made as to the future course of action. If no suitable candidate comes forward, the process will be discontinued, and PE will continue in its normal operating mode.

This Year in Review cont...

Raider Resources Ltd.
(RAI-ASE)

One year ago, the fund owned 1,135,50 shares of RAI, purchased at a cost of $0.15 per share. Sometime later, the Company was reorganized, including a 1-for-8 share consolidation. We later bought an additional 50,000 shares to bring our average purchase price to $1.12 per share. Subsequent to that corporate reorganization, goals and the strategy to implement them were established:
(i) focus on oil and gas prospects in the Calgary-Edmonton corridor;
(ii) farm-out or sell all properties not located within that defined "core" area;
(iii) have a production/sales volume split approximately 50/50 oil and gas;
(iv) revenues of $10-million this year (1997); and
(v) a TSE listing. Revenues are not yet at the $10-million level, but all else has been accomplished.

Corporate strengths of Raider Resources Ltd. include:
(i) debt/cash flow ratio of approximately eight months, based on an estimate of 1997 results;
(ii) excellent potential for oil and gas discoveries within the Calgary-Edmonton corridor where multi-zone oil and gas reservoirs are present. Weaknesses to overcome are:
(i) potential income tax liability this year as the company has minimal tax pools to offset tax liabilities, and
(ii) does not have much undeveloped acreage to exploit. Both of these items are being attended to by management and we believe our investment will work out well.

Westward Energy Ltd.
(WEL.A-TSE)

This investment never did reach our expectations: exploration success did not meet corporate projections, and the company continued to experience production declines not offset by new discoveries. In a sense, the company was land rich but cash poor. Effective August 1, 1997, all that changed via a merger with Seventh Energy Ltd. which is the surviving company. That latter company brings about $7.5-million in cash to the new entity, which combined with the undeveloped acreage from the Westward side, means a much stronger organization. Thirty-to-forty wells will be drilled prior to year-end. The Chairman and C.E.O. of Seventh Energy Ltd. was one of the principal founders of Pinnacle Resources Ltd., a Canadian oil and gas company. Management of both Seventh and Westward believe that it will be easier to raise new capital and to use internally generated funds to conduct further oil and gas exploration and development activities. Westward shares are being converted into Seventh Energy Ltd. shares on the basis of one WEL.A share for 0.6 Seventh Energy Ltd. share. We will convert our holdings of WEL.A accordingly and hope to recoup our investment in what appears to be a much stronger oil and gas situation.

Zargon Oil & Gas Ltd.
(ZAR-TSE)

ZAR was one of our first investments and it continues to be a very strong component of the Southesk portfolio. Our average cost is $1.47 per share, approximately one-half of current trading price. The Company continues to do very well. Management is able to meet its goals of approximately 20% increase per annum in production, reserves, cash flow, and net earnings, all expressed per share. At June 30, 1997, the Company had already reached its production goal for the year. Over its history, ZAR has successfully met its objectives to deliver a combined and compounded growth rate of 23% in these parameters over its seven-year history. We see no reason to disassociate ourselves from this particular oil and gas situation.

The debt/cash flow ratio represents four months of 1997 results, and the net asset value is close to $3.00 per share, both factors indicative of the financial strength of this junior oil and gas company. The Company has operations in both east central Alberta, and in southeastern Saskatchewan.

Auditor's Report

To The Shareholders of Southesk Energy Ltd.

We have audited the balance sheet of Southesk Energy Ltd. as at June 30, 1997, and the statements of earnings and retained earnings and changes in financial position for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at June 30, 1997, and the results of its operations and changes in its financial position for the year then ended in accordance with generally accepted accounting principles.

Deloitte & Touche.

Chartered Accountants
July 22, 1997

Balance Sheet

June 30, 1997

	1997	1996
ASSETS		
CURRENT		
Cash and term deposits	**$ 1,417,220**	$ 63,674
INVESTMENTS (Note 3)	**2,938,170**	1,577,386
RESOURCE PROPERTIES (Note 4)	**134,469**	-
	$ 4,489,859	$ 1,641,060
LIABILITIES		
CURRENT		
Accounts payable	**$ 2,000**	$ 2,000
Income taxes payable	**-**	4,217
	2,000	6,217
SHAREHOLDER'S EQUITY		
Share Capital (Note 5)	**4,343,501**	1,567,382
Retained earnings	**144,358**	67,461
	4,487,859	1,634,843
	$ 4,489,859	$ 1,641,060

APPROVED BY THE BOARD

R G Logan Director

L Sanders Director

Statement of Earnings and Retained Earnings

Year ended June 30, 1997

	1997	1996
REVENUE		
Gain on sale of investments	**$ 147,820**	$ 91,913
Interest income	**18,290**	6,162
	166,110	98,075
EXPENSES		
Advisory fees	**45,263**	24,404
Office and administrative	**21,221**	18,110
Rent	**17,120**	12,840
Professional fees	**5,609**	4,396
	89,213	59,750
EARNINGS BEFORE INCOME TAXES	**76,897**	38,325
INCOME TAXES (Note 6)	**-**	4,217
NET EARNINGS	**76,897**	34,108
RETAINED EARNINGS, BEGINING OF YEAR	**67,461**	33,353
RETAINED EARNINGS, END OF YEAR	**$ 144,358**	$ 67,461
EARNINGS PER SHARE		
Basic	**$ 0.080**	$ 0.035
Fully-diluted	**0.052**	0.035

Statement of Changes in Financial Position

Year ended June 30, 1997

	1997	1996
NET INFLOW (OUTFLOW) OF CASH RELATED TO THE FOLLOWING ACTIVITIES		
OPERATING		
Net earnings	$ 76,897	$ 34,108
Item not affecting cash		
Gain on sale of investments	(147,820)	(91,913)
	(70,923)	(57,805)
Changes in non-cash operating working capital items		
Income taxes payable	(4,217)	649
	(75,140)	(57,156)
INVESTING		
Purchase of investments	(2,026,702)	(1,294,028)
Proceeds on disposal of investments	813,738	957,173
Purchase and exploration of resource properties	(134,469)	-
	(1,347,433)	(336,855)
FINANCING		
Issuance of share capital	3,000,000	6,750
Share issue costs	(223,881)	-
	2,776,119	6,750
NET CASH INFLOW (OUTFLOW)	1,353,546	(387,261)
CASH AND TERM DEPOSITS, BEGINNING OF YEAR	63,674	450,935
CASH AND TERM DEPOSITS, END OF YEAR	$ 1,417,220	$ 63,674

Notes to the Financial Statements

Year ended June 30, 1997

1. **NATURE OF BUSINESS**

The Company was incorporated under the provisions of the Business Corporations Act (Alberta) on March 8, 1993 and commenced operations on July 1, 1994. The Company holds investments in oil and gas companies for capital appreciation and does not intend to trade in securities for short term gains.

2. **ACCOUNTING POLICIES**

These financial statements have been prepared in accordance with generally accepted accounting principles and include the following significant accounting policies:

Investments

Investments are recorded at cost. When it becomes apparent that a permanent decline in the value of an investment has occurred, the investment is written down to reflect such a decline.

Resource Properties

The Company follows the full-cost method of accounting for oil and gas properties whereby all costs relative to the exploration for and development of oil and gas reserves are capitalized. Costs will be amortized on a unit-of-production basis at such time as production commences or charged against income if the property is abandoned or a permanent decline in value occurs.

3. INVESTMENTS

	1997			1996	
	Number of shares	**Cost**	**Market**	Number of shares	Cost
Canadian Conquest Exploration Inc.	**96,000**	**$ 163,245**	**$ 130,560**	-	$ -
Chauvco Resources Ltd.	**40,500**	**662,795**	**799,875**	-	-
Crestar Energy Inc.*	-	-	-	5,891	131,603
Draig Resources Ltd.	-	-	-	75,000	20,590
Fossil Oil & Gas Ltd.	-	-	-	85,000	237,698
Hurricane Hydrocarbons Ltd.	**60,900**	**258,885**	**304,500**	24,300	59,301
Newport Petroleum Corporation	**68,000**	**464,779**	**493,000**	-	-
Oiltec Resources Ltd.	**241,500**	**290,309**	**495,075**	150,000	158,947
Palliser Energy Ltd.	**437,500**	**329,132**	**546,875**	300,000	197,925
Pointer Exploration Corp.	**55,000**	**69,304**	**64,900**	-	-
Raider Resources Ltd.**	**191,937**	**214,757**	**220,728**	1,135,500	169,082
Saxon Petroleum Ltd.	-	-	-	290,000	162,883
Westward Energy Ltd.	**175,300**	**273,110**	**140,520**	121,300	225,319
Zargon Oil & Gas	**143,400**	**211,854**	**372,840**	158,500	214,038
	1,510,037	**$ 2,938,170**	**$ 3,568,873**	2,345,491	$ 1,577,386

*Previously Petrostar Petroleums Inc.

**Reflects 8 for 1 consolidation

4. RESOURCE PROPERTIES

During the year, the Company entered into a joint operating agreement whereby the Company obtained an 11.25% working interest in oil and gas properties located in southeastern Saskatchewan.

5. SHARE CAPITAL

Authorized

Unlimited number of voting common shares

Unlimited Series A 6% cumulative, non-voting, redeemable and convertible preferred shares

	1997	1996
Issued		
965,500 common shares (1996 - 965,500 common shares)	**$ 1,567,382**	$ 1,567,382
400,000 Series A preferred shares (1996 - nil)	**2,776,119**	-
	$ 4,343,501	$ 1,567,382

During the year, the Company authorized and issued 400,000 Series A preferred shares at $7.50 per share. The Company incurred $223,881 of share issue costs which have been netted against the gross proceeds received from the issued preferred shares. Dividends are to be paid semi-annually commencing September 30, 1997. The shares are subject to redemption at 106% of the issue price in the first year, 105% in the second year, 104% in the third year, 103% in the forth year, and at par thereafter. Each preferred share is also convertible within five years of the date of issuance and at the option of the holder into two common shares.

Of the 965,500 issued voting common shares, 46,800 shares are held in escrow pursuant to a policy of the Alberta Securities Commission and may not be released from escrow without the consent of the Chief of Securities Administration.

Stock Options

On June 30, 1994, the Company established a Stock Option Plan and granted stock options to its directors totalling 89,000 common shares at $2 per share which may be exercised until June 30, 1999. On February 18, 1997, the Company granted additional stock options to its directors totalling 40,000 Series A preferred shares at $7.50 per share which may be exercised until February 18, 2002. None of these options have been exercised as of June 30, 1997.

Pursuant to the 1997 share offering, the Company granted its agent, the brokerage firm of Sanders & Beckingham Securities Ltd., stock options totalling 40,000 Series A preferred shares at $7.50 per share which may be exercised until February 14, 1999. None of these options have been exercised as of June 30, 1997.

6. COMMITMENT

The Company has entered into an Advisory Agreement for investment advisory services for the year ending June 30, 1998. Under the terms of the agreement, the Adviser will be paid, on a monthly basis, one-twelfth of 1-1/2% of the total market value of the Company's investment portfolio.

7. INCOME TAXES

The Company's effective tax rate approximates 44%. The provision for income taxes does not reflect this rate as the Company is allowed to deduct , over a five year period, a portion of share issue costs incurred to determine its taxable income. These costs have been netted against share capital in the financial statements (Note 5)

8. RELATED PARTY TRANSACTIONS

A Director of the Company is also a partner in a legal firm which provided legal services to the Company in the amount of $11,476 during the year (1996 - $2,120).

9. FINANCIAL INSTRUMENTS

Financial instruments consist of recorded amounts of cash and term deposits, investments which will result in future cash receipts, as well as accounts payable which result in future cash outlays.

Fair value

Definition

Estimated fair values approximate the amounts at which financial instruments could be exchanged in a current transaction between willing parties under no compulsion to act.

Limitations

Fair value estimates are made at a specific point in time and are based on relevant market information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgement and, there fore, cannot be determined with precision. Changes in assumptions would significantly affect the estimates.

Cash and term deposits and accounts payable

The estimated fair value of each of these instruments approxi mates the carrying value because of their limited term.

Investments

The fair value of the investments approximates the market values disclosed in Note 3.

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David S. Rowand, Secretary

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David S. Rowand*
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Historical Profits

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